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Selecting the Legal Structure for Your Firm

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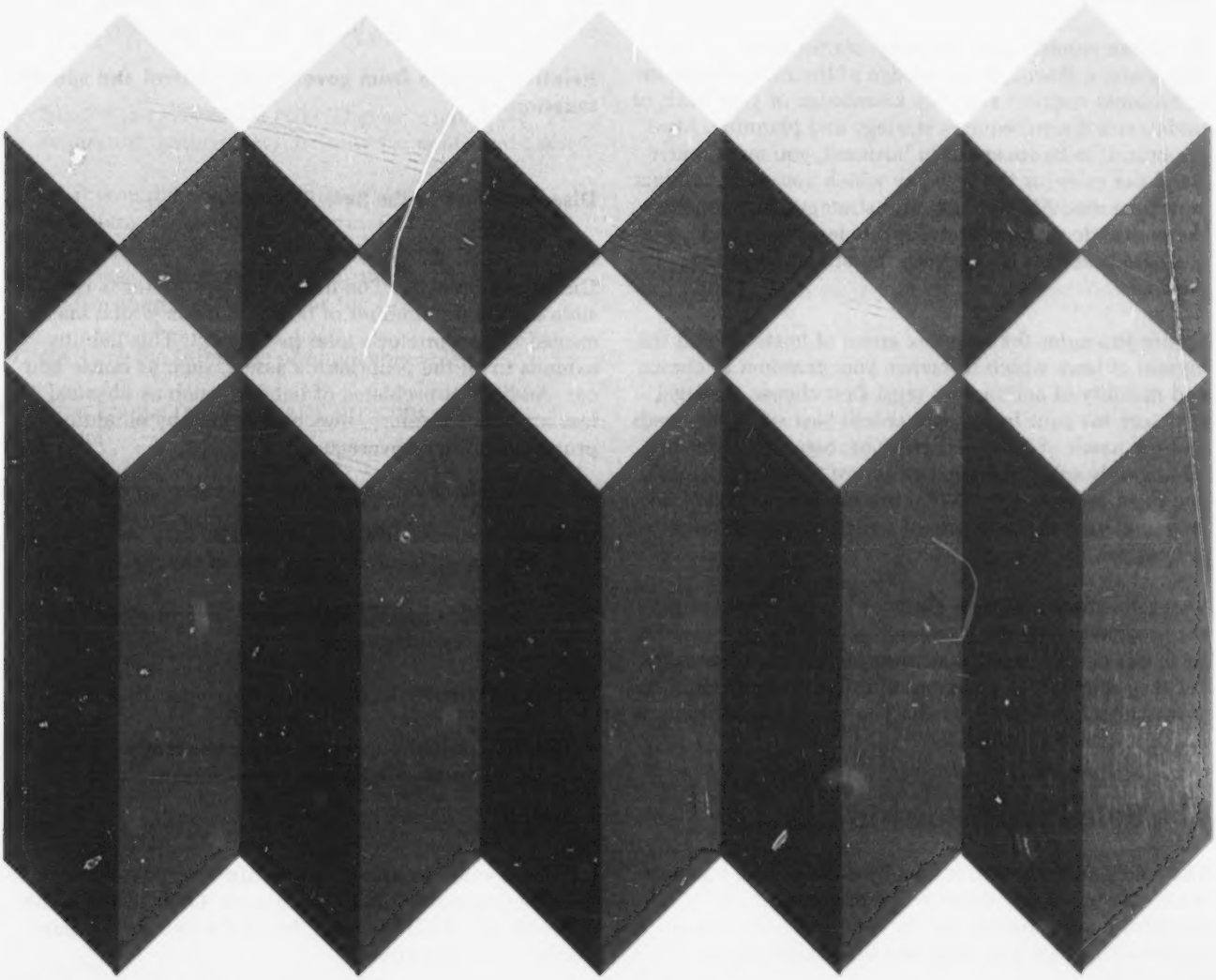

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Summary

There are many reasons today for owner-managers of small businesses to look at the legal structure of their firms. The changing tax laws and fluctuating availability of capital are just two situations which require alert managers to review what legal structures best meets their needs.

Each form of business organization has its advantages and disadvantages. This Aid seeks to briefly identify them for the owner-manager who wants to know "what questions to ask" when seeking the proper professional advice.

If you were to make an analogy between starting a business and playing a card game, you might say, "The game is just for fun, but business is business." Well, you would be right. But let's consider some important similarities.

The game requires skill, strategy, planning, and, most important, a thorough knowledge of the rules. Going into business requires skill (the knowledge of your craft or trade), and it also requires strategy and planning. Most important, to be sucessful in business, you must understand the rules (or the laws) by which you must conduct your business. All planning and strategy must consider the multitude of local, state, and federal laws and business practices that govern the operation of the business.

Before you enter the complex arena of business and the myraid of laws which influence your freedom of choice and mobility of action, you must first choose the legal structure for your business that will best suit your needs and the needs of your particular business. In order to intelligently select the legal structure for your business, you must ask yourself, "What are my alternatives?" So, let's now look at the nature of various legal business structures.

There are three principal kinds of business structures: the proprietorship, the partnership, and the corporation. Each has certain general advantages and disadvantages, but they must all be weighted to reflect your specific circumstances, goals, and needs. The sole proprietorship is the first firm we'll consider.

The Sole Proprietorship

The sole proprietorship is usually defined as a business which is owned and operated by one person. To establish a sole proprietorship, you need only obtain whatever licenses you need and begin operations. Hence, it is the most widespread form of small business organization.

Advantages of the Sole Proprietorship

Ease of formation. There is less formality and fewer legal restrictions associated with establishing a sole proprietorship. It needs little or no governmental approval and is usually less expensive than a partnership or corporation.

Sole ownership of profits. The proprietor is not required to share profits with anyone.

Control and decision making vested in one owner. There are no co-owners or partners to consult. (Except possibly your spouse.)

Flexibility. Management is able to respond quickly to business needs in the form of day to day management decisions as governed by various laws and good sense.

Relative freedom from government control and special taxation.

Disadvantages of the Sole Proprietor

Unlimited liability. The individual proprietor is responsible for the full amount of business debts which may exceed the proprietor's total investment. This liability extends to all the proprietor's assets, such as house and car. Additional problems of liability, such as physical loss or personal injury, may be lessened by obtaining proper insurance coverage.

Unstable business life. The enterprise may be crippled or terminated upon illness or death of the owner.

Less available capital, ordinarily, than in other types of business organizations.

Relative difficulty in obtaining long-term financing.

Relatively limited viewpoint and experience. This is more often the case with one owner than with several.

NOTE: A small business owner might very well select the sole proprietorship to begin with. Later, if the owner succeeds and feels the need, he or she can form a partnership or corporation.

The Partnership

The Uniform Partnership Act, adopted by many states, defines a partnership as "an association of two or more persons to carry on as co-owners of a business for profit." Though not specifically required by the Act, written Articles of Partnership are customarily executed. These articles outline the contribution by the partners into the business (whether financial, material or managerial) and generally delineate the roles of the partners in the business relationship. The following are example articles typically contained in a partnership agreement:

Name, Purpose, Domicile

Duration of Agreement

Character of Partners (general or limited, active or silent)

Contributions by Partners (at inception, at later date)

Business Expenses (how handled)

Authority (individual partner authority in conduct of business)

Separate Debts

Books, Records, and Method of Accounting

Division of Profits and Losses

Draws or Salaries

Rights of Continuing Partner

Death of a Partner (dissolution and winding up)

Employee Management

Release of Debts

Sale of Partnership Interest

Arbitration

Additions, Alterations, or Modifications of Partnership Agreement

Settlements of Disputes

Required and Prohibited Acts

Absence and Disability

Some of the characteristics that distinguish a partnership from other forms of business organization are the limited life of a partnership, unlimited liability of at least one partner, co-ownership of the assets, mutual agency, share of management, and share in partnership profits.

Kinds of Partners

Ostensible Partner. Active and known as a partner.

Active Partner. May or may not be ostensible as well.

Secret Partner. Active but not known or held out as a partner.

Dormant Partner. Inactive and not known or held out as a partner.

Silent Partner. Inactive (but may be known to be a partner).

Nominal Partner (Partner by Estoppel). Not a true partner in any sense, not being a party to the partnership agreement. However, a nominal partner holds him or herself out as a partner, or permits others to make such representation by the use of his/her name or otherwise. Therefore, a nominal partner is liable as if he or she were a partner to third persons who have given credit to the actual or supposed truth of such representation.

Subpartner. One who, not being a member of the partnership, contracts with one of the partners in reference to participation in the interest of such partner in the firm's business and profits.

Limited or Special Partner. Assuming compliance with the statutory formalities, the limited partner risks only his or her agreed investment in the business. As long as he or she does not participate in the management and control of the enterprise or in the conduct of its business, the limited partner is generally not subject to the same liabilities as a general partner.

Advantages of the Partnership

Ease of formation. Legal informalities and expenses are few compared with the requirements for creation of a corporation.

Direct rewards. Partners are motivated to apply their best abilities by direct sharing of the profits.

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Growth and performance facilitated. In a partnership, it is often possible to obtain more capital and a better range of skills than in a sole proprietorship.

Flexibility. A partnership may be relatively more flexable in the decision making process than in a corporation. But, it may be less so than in a sole proprietorship.

Relative freedom from government control and special taxation.

Disadvantages of a Partnership

Unlimited liability of at least one partner. Insurance considerations such as those mentioned in the proprietorship section apply here also.

Unstable life. Elimination of any partner constitutes automatic dissolution of partnership. However, operation of the business can continue based on the right of survivorship and possible creation of a new partnership. Partnership insurance might be considered.

Relative difficulty in obtaining large sums of capital. This is particularly true of long term financing when compared to a corporation. However, by using individual partners' assets, opportunities are probably greater than in a proprietorship.

Firm bound by the acts of just one partner as agent.

Difficulty of disposing of partnership interest. The buying out of a partner may be difficult unless specifically arranged for in the written agreement.

The Corporation

The corporation is by far the most complex of the three business structures. For the purpose of this *Aid*, we shall discuss only the general characteristics of the corporation, not its intricacies.

As defined by Chief Justice Marshall's famous decision in 1819, a corporation "is an artificial being, invisible, intangible, and existing only in contemplation of the law." In other words, a corporation is a distinct legal entity, distinct from the individuals who own it.

Formation of the Corporation

A corporation usually is formed by the authority of a state government. Corporations which do business in

more than one state must comply with the Federal laws regarding interstate commerce and with the state laws, which may vary considerably.

The procedure ordinarily required to form a corporation is that, first, subscriptions for capital stock must be taken and a tentative organization created. Then, approval must be obtained from the Secretary of State in the state in which the corporation is to be formed. This approval is in the form of a charter for the corporation, stating the powers and limitations of the particular enterprise.

Advantages of the Corporation

Limitations of the stockholder's liability to a fixed amount of investment. However, do not confuse corporate liability with appropriate liability insurance considerations.

Ownership is readily transferable.

Separate legal existence.

Stability and relative permanence of existence. For example, in the case of illness, death, or other cause for loss of a principal (officer or owner), the corporation continues to exist and do business.

Relative ease of securing capital in large amounts and from many investors. Capital may be acquired through the issuance of various stocks and long term bonds. There is relative ease in securing long term financing from lending institutions by taking advantage of corporate assets and often personal assets of stockholders and principals of guarantors. (Personal guarantees are very often required by lenders.)

Delegated authority. Centralized control is secured when owners delegate authority to hired managers, although they are often one and the same.

The ability of the corporation to draw on the expertise and skills of more than one individual.

Disadvantages of the Corporation

Activities limited by the charter and by various laws. However, some states do allow very broad charters.

Manipulation. Minority stockholders are sometimes exploited.

Extensive government regulations and required local, state, and federal reports.

Less incentive if manager does not share in profits.

Expense of forming a corporation.

Double tax - income tax on corporate net income (profit) and on individual salary and dividends.*

*You should be aware, also, of the possibility of selecting subchapter S status (IRC 1371-1379). The purpose of subchapter S is to permit a "small business corporation" to have its income taxed to the shareholders as if the corporation were a partnership. One objective is to overcome the double tax feature of our system of taxing corporate income and stockholder dividends. Another purpose is to permit the shareholders to have the benefit of offsetting business losses incurred by the corporation against the income of the shareholders.

Among the conditions for the making and maintenance of subchapter S election are that the corporation have ten or fewer shareholders, all of whom are individuals or estates, that there be no nonresident alien shareholders, that there be only one class of outstanding stock, that all shareholders consent to the election, and that a specific portion of the corporation's receipts be derived from active business rather than enumerated passive investments. No limit is placed on the size of the corporation's income and assets.

In summary, review the following eight questions:

1. What is the size of the risk? That is, what is the amount of the investors' liability for debts and taxes?
2. What would the continuity (life) of the firm be if something happened to the principal or principals?
3. What legal structure would insure the greatest adaptability of administration for the firm?
4. What are the influence of applicable laws?
5. What are the possibilities of attracting additional capital?
6. What are the needs for and possibilities of attracting additional expertise?
7. What are the costs and procedures in starting?
8. What is the ultimate goal and purpose of the enterprise, and which legal structure can best serve its purposes?

The small businessowner is required to wear many hats, but none can be expected to be a lawyer, certified public accountant, marketing specialist, production engineer, environmental specialist, etc. Therefore, you should get the facts before making decisions. When necessary and if possible, you should also get professional counsel to help you avoid misunderstanding technical or legal issues and avoid making bad decisions and false starts that require backtracking and added expense. This is especially true when you are deciding what legal form to adopt. This *Aid* has presented an introduction to the options and guidelines for selecting the best legal structure for your business.

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